May 9, 2007

Mr. Winston Hickox, Chair
Dr. Lawrence Goulder, Vice Chair
AB32 Market Advisory Committee
c/o California Environmental Protection Agency
1001 I Street, 15th Floor
Sacramento, CA 95818

Re: Comments to the Second Public Meeting of the Market Advisory Committee

Dear Chairman Hickox, Vice Chairman Goulder, and Committee Members:

AES Southland LLC ("Southland"), a wholly owned subsidiary of The AES Corporation (NYSE:AES), hereby submits its initial comments to the second public hearing of the Market Advisory Committee (MAC) held on April 17, 2007. AES Southland and affiliated AES companies own and operate 4,400 MWs of natural gas and biomass generation in California, which represents approximately 7.5% of California's installed capacity. The Southern California assets alone are capable of supplying up to 19% of Southern California Edison's 2006 peak electricity demand.

The AES Corporation is a leading global power company with 123 electricity generating facilities in 26 countries on five continents with an installed capacity of over 44 gigawatts. AES also delivers electricity to consumers around the world through 14 regulated utilities. Internationally, the plants AES owns are subject to both the European Union's Emission Trading System and the Kyoto Protocol. AES has experience operating under these regulations as a regulated entity, an offset developer and a market trading participant. It has both contract and merchant generating assets. AES generates power in industrialized and developing countries using coal, gas and oil, as well as through a portfolio of renewable wind and hydro sources.

As a general policy, Southland supports market-based emission reduction programs. These types of programs have been demonstrated to lower compliance costs associated with environmental mandates and promote new technology. In addition, in order to address leakage issues, absent a national program, Southland endorses a load-based cap applied to all load-serving entities (LSEs) that deliver power to California load, as compared to a source-based or hybrid approach. This approach is consistent with methodology being recommended by the California Public Utilities Commission (CPUC) and the California Energy Commission (CEC). Such a program would permit LSEs to average their overall generation profile to meet GHG reduction targets at the lowest cost and also capture the impact associated with imported power.

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Regardless of who has the ultimate compliance obligation, the issue of how to distribute allowances continues to be widely discussed in the MAC public meetings. This issue will no doubt be an important part of any MAC recommendations made to the California Air Resources Board (CARB) in June of this year. A central element of the auction versus free allocation (grandfathering) debate revolves around the ability of an industry sector or a particular business to pass through the cost of allowances. The ability of a sector or business to pass through allowance costs, taken together with any subsequent reduction in demand due to higher prices, determines the net economic impact of any allowance distribution methodology that is adopted.

With this in mind, it is critical that MAC understands there are Independent Power Producers (IPPs) who own and operate important power plants in California with existing long-term contracts that may have different pass-through mechanisms or may not allow any pass-through of CO2 allowance costs, depending on the terms of those long-term contracts and the law. Most of these IPP units are fired with natural gas, have been retrofitted with state-of-the-art emission controls, and are inherently cleaner than the coal-based power imported into the state. The viability of these important IPPs, however, could be threatened by an extreme economic burden associated with either an insufficient grandfathered allocation or an auction process, contrary to the policy of reducing CO2 emissions. Given California's reliance on the power generated by IPPs to meet summer peak demands and serve vital local reliability needs, we respectfully submit that any recommendations on allocations and auctions must take into consideration the potential economic impact of these costs on the IPPs. Indeed, under Section 38562 (b)(1), the Legislature instructs CARB to "Design the regulation, including distribution of emission allowances where appropriate, in a manner that is equitable..."

Consistent with the concept of an equitable distribution, generators operating under existing long-term contracts that may not possess full pass through mechanisms must not be placed at an economic disadvantage compared to similar facilities due to the implementation of this program. Therefore, the MAC recommendations should support the load-based cap that is currently being proposed by the CPUC and CEC. This concept not only addresses the problem of leakage, but puts the compliance obligation on the entities that are usually the recipients of the power delivered by the generators that have long-term contracts in place. To be clear, AES as a whole advocates a national, market-based cap and trade system where the compliance obligation is on the source. However, until a national program is enacted, an LSE based approach is most effective structure to address imported power.

If the compliance obligation does ultimately fall on the in-state generators and a partial or full auction approach is adopted, the MAC must include a mechanism in its recommendations for generators without pass-through ability to recoup their respective demonstrated CO2 allowance costs until the expiration of their existing contracts.

Alternatives that should be explored include:

1. Provide the long-term contracted generator with full recovery of CO_2 allowance costs until contract expiration. Specifically, the long-term contracted generator would participate in the allowance auction and purchase the required allowances. A portion of the auction proceeds would be utilized to provide cost recovery to the impacted generators on a dollar-for-dollar basis.

2. Create an allowance reserve account set aside for long-term contracted generators that do not have pass through ability. The impacted generator would receive the required allowances through this account until the expiration of the contract. Once the contract expires, the allowances would be returned to the larger market allowance account and the generator would be treated like any other merchant generator.

3. Allocate allowances to these generators through grandfathering and not auction until the term of the contract expired.

4. Require the contract off-taker to reimburse the long-term contracted generator for the cost of the CO_2 allowances until the contract expires. The power purchaser, who is most frequently the load serving entity, can recover the costs through either its daily bid into the market or its established rates.

Any of these mechanisms can be developed in such a way to avoid the allocation of excess allowances and meet overall reduction targets.

In summary, AES recognizes the issues associated with developing climate change regulations are numerous and complex. We have chosen to limit our comments to a few issues because we feel it is crucial that the MAC clearly understands the ramifications of their recommendations related to who has the compliance obligation in the power sector and how allowances are distributed. There are numerous generators in California that have long-term contracts in place that may not allow the pass through of CO2 costs. Those generators should not be unfairly penalized for having contracts in place that provide a reliable, long-term supply of power to California.

We are available at your convenience to discuss our recommendations further and to answer any questions you might have. Please do not hesitate to call me at 714-374-1421. Thank you for your consideration.

Sincerely,

Eric Pendergraft
President, AES Southland LLC